Evaluating the Budget Surplus and Tax Policy Options

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Testimony by:

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Mr. Chairman and Members of the Committee:

Thank you for giving me the opportunity to discuss the budget outlook and the options for tax policy. My testimony is divided into two sections. The first provides a summary; the second provides the background analysis that supports these views.

Summary

1. The Budget Outlook

The most recent Congressional Budget Office baseline forecast projects cumulative surpluses of $5.6 trillion between 2002 and 2011. But there is really only $1.7 trillion or less that can be thought of as "available" for new tax cuts or new spending, under responsible budgeting practices and realistic forecasts of tax and spending policies.

Almost 60 percent of the projected surplus is due to accumulations in retirement trust funds. No financially responsible firm would consider its pension reserves as a source of financing for current operating expenses, and neither should the federal government. Both Houses of Congress have shown overwhelming support for protecting the social security and medicare trust funds, because they represent current tax collections that are committed to future uses. Cordoning off social security reduces the available surplus to $3.1 trillion. Protecting the Medicare trust fund reduces the amount to $2.7 trillion. Protecting the pension reserves of government military and civilian workers—which makes sense for same reasons as protecting social security and medicare—would reduce the available surplus to $2.3 trillion.

Extending the temporary tax provisions, and fixing problems that already exist under current law with the alternative minimum tax reduces the available funds to $2.1 trillion. Allowing real discretionary spending per person to remain constant reduces the amount of available funds to $1.7 trillion over the next 10 years. If discretionary spending were to grow at the rate of GDP, the available surplus would fall to $1.0 trillion.

There is nothing sacrosanct about a 10-year planning horizon. For public policies such as social security and medicare, the official planning horizon is 75 years. Looking beyond the 10-year horizon is particularly important for assessing the budget outlook because the rapid growth in entitlement programs driven by an aging population and rapidly rising medical care expenditures is not projected to begin until later dates. Despite current surpluses, estimates in this testimony show that the government continues to face a long-term financial shortfall. This fundamental fact counters claims that Americans are being "overcharged" for government currently.

2. President Bush's Budget and Tax Proposals

The President's budget threatens to undo most or all of the hard-won fiscal gains of recent years. The budget is hugely fiscally irresponsible in two main ways.

First, the President proposes to divert about $1 trillion of social security and medicare surpluses from the trust funds for those programs. He would take $600 billion of surplus in the social security trust fund and place it in a general "reserve" fund that could be used for any future (and currently unspecified purpose). He would spend the $400 billion surplus in the medicare part A trust fund on supplemental medical insurance for the elderly (Medicare part B), even though Medicare part A is in long-term deficit, and even though part B is funded by general revenues and insurance premia by statute.

Second, the President has proposed a massive tax cut. The tax cut in his budget differs from the tax cut he sent up to Congress just a month earlier. The tax cut would cost in excess of $2 trillion, inculding interesting costs. As implemented in HR 3, the tax cut would leave 36 million on the AMT by 2011. Fixing that problem would raise the cost to over $2.5 trillion.

Thus, the President's budget:

--violates the otherwise consensus view that social security and medicare funds should be protected and effectively diverts $1 trillion from those funds to other purposes;

--proposes a tax cut that would use up the entire non-social security, non-medicare budget, according to the President's own proposals;

--would leave no funding left for anything else, without either tapping into retirement trust funds or running a deficit, for the next decade.

3. Evaluating the President's Tax Proposals

The Administration has had a very difficult time providing a coherent justification for its tax package. Notably, the President's justifications for his tax proposal keep changing, but the proposal does not

Over the next 10 years, HR3, the other components of the tax plan that the President sent to Congress on February 8, and the new proposals in the budget would cut taxes by about $1.8 trillion. The AMT adjustments would total $292 billion, and the added interest payments on the federal debt caused by the reduction in federal revenues would cost another $418 billion. Thus, although the proposal is often referred to as a $1.6 trillion tax cut, the real cost would be exceed $2.5 trillion over the next 10 years. This is much larger than the "available surplus" noted above, and implies that no other policy priorities could not be met unless Congress were willing to finance new programs with balances in the retirement trust funds or with deficit spending.

The proposed tax cut would roughly triple the severity of the long-term fiscal problem. Properly adjusted, Bush's tax cut is about as large as the net tax cut created by the 1981 and 1982 tax acts. But taxes on most families were much higher then than they are now, and tax rates had been rising steadily rising in years before that. In recent years, the tax burdens on most families have fallen.

Besides being too large, the Administration's tax cut would be disproportionately tilted toward high-income taxpayers, who would receive a bigger percentage decline in tax payments, a bigger percentage increase in after-tax income, a bigger share of the total tax cut than their current tax share, and a gigantic cut in dollar amounts. The Administration' rhetoric on distributional effects has been particularly misleading and disingenuous.

The President's efforts to "take down the tollbooth to the middle class" and to address the marriage penalty leave out households with earnings below $20,000, who often face the highest effective tax rates and the largest marriage penalties.

One of the most puzzling and misleading aspects of the President's defense of the tax cut is his claim that it would be an effective way to fight a brewing recession. It is not clear that a recession will emerge, and most economists (myself included) feel that tax policy is poor way to counter a recession. Even if tax policy were a good way to counter a recession, the President's tax proposal is incredibly poorly designed for that purpose. It is so big it would raise interest rates, which would hurt the economy. It is delayed (no tax cuts in 2001 and only $20 billion in 2002), and so can not help fight a recession now. And it is geared toward high-income households, when it is low- and middle-income households that would be most likely to lose their job and most likely to spend the tax cut.

Another argument the president uses to justify tax cuts is that tax revenues are at historic highs and therefore that Americans are being crushed by overburdensome taxes. But if a high aggregate federal tax burden justifies tax cuts, it should justify cuts in a variety of taxes, not just the income and estate taxes. About 74 percent of families pay more in payroll taxes, for example, than in income taxes. Focusing tax cuts only on income taxes and estate taxes thus ignores the major tax burden facing almost three-quarters of American families. In fact, for most families, taxes are as low or lower than they have been in the past 20-30 years. Overall tax payments have risen because the rich have gotten richer at an impressive rate.

Some argue that tax cuts are needed to prevent government from going on a spending spree. There is clearly some validity to this concern, but the vast portions of existing surpluses have been allowed to accumulate, and discretionary spending is a smaller share of GDP today than it has been in any year since at least 1962, so the argument is weakened considerably. And it is Congress that has been willing to cordon off Medicare, not the Administration. Finally, even if this argument justifies a tax cut, it does not provide a rationale for why the tax cut should be focused on the highest-income households.

An argument put forth recently by Alan Greenspan, and quickly repeated by tax cut advocates, is that under current surplus projections, the government will pay off all available government debt by around 2006 or shortly thereafter. Greenspan and others argue that having the federal government hold such assets would raise a number of difficult issues. These issues are real, but the concerns are seriously overstated. Currently, for example, state and local government pension funds hold private assets equal to 28 percent of GDP.

4. Policy Options

The current fiscal surpluses are a significant accomplishment, and should not be taken lightly or for granted. There is clearly room for a tax cut, for spending priorities, and for debt reduction. But I believe that the most important budgeting decision for the Congress is to establish a new set of budget rules, and that these rules should be established before making a significant set of tax and spending changes.

A. Budget rules

The fiscal accomplishments of the last decade should be preserved and enhanced, not squandered. The old rules are expiring. And the current budget situation has dangers associated with it, since there are short-run surpluses but long-term deficits. Consideration of policy rules should take several factors into account. First, there is a certain asymmetry in policy options. It is always easier to reduce taxes later than to raise them. Second, new and unforeseen policy priorities frequently arise, so prudent fiscal management would suggest the equivalent of a "reserve fund" of some sort. Third, both budget projections and economic forecasts are subject to considerable uncertainty, which suggests another reason not to commit all available resources immediately.

--Reaffirm the commitment to protect social security and medicare and extend the same treatment to government pension reserves.

--Adopt a proposal put forth recently by Robert Reischauer to cordon off increasing amounts of future surpluses from current commitments.

B. Tax Policy

Tax policy should be made inside of a budgetary framework that recognizes the importance of other public policy goals—such as education, health, defense, the refurbishing of social security and medicare and so on. In addition, fairness, efficiency, and simplicity remain the core principles of tax policy regardless of the size of the surplus.

--Create a new, lower tax bracket of 10-12 percent, covering a range of income broader than the 10 percent bracket proposed by proposed by President Bush.

--Combine or integrate interactions between the child credit, earned income credit, and personal exemption. This would simplify taxes, improve incentives to work and marry, and provide added resources to low-income households. A crucial element would be to increase the refundability of the child credit.

--Simplify the tax code by raising the standard deduction, providing a uniform exclusion for capital gains income rather than the complicated patchwork of capital gains tax rates we currently have.

--Provide tax cuts to high-income taxpayers and simplify the tax system further by removing the phaseout of personal exemptions and the limitations on itemized deductions. Either reform or abolish the alternative minimum tax.

--Reform the estate tax by raising the effective exemption, modestly reducing rates, indexing the tax for inflation, and closing down a number of egregious sheltering practices.

Evaluating the Budget Surplus and Tax Policy Options

1. The Budget Outlook

After decades of deficits, the federal budget has recently yielded increasing annual surpluses. The most recent Congressional Budget Office baseline forecast, released in January projects cumulative surpluses of $5.6 trillion between 2002 and 2011, including $2.5 trillion in the social security trust fund (the “off budget” surplus) and $3.1 trillion in the rest of the budget (the “on-budget” surplus).

Just as perennial budget deficits dominated policy discussions in the 1980s and early 1990s, choices regarding how to use these surplus will shape fiscal debates for years to come. Debates regarding these choices are almost always carried out in the context of CBO’s baseline forecast. However, while it provides a common and visible benchmark, CBO’s baseline is limited in several crucial ways and does not provide sufficient information to assess various policy options.

To assess policy options accurately requires a measure of the surplus that would be available for tax cuts or new spending under responsible budgeting procedures, plausible assumptions about the maintenance of current policy, and appropriate time horizons. To obtain these measures, it is necessary to adjust the baseline forecast for the treatment of retirement funds, the definition of “current policy;” and the time horizon employed. These adjustments provide different perspectives on the size of the available surplus and generally imply that the funding likely to be available for new tax cuts or spending programs is substantially less than the baseline forecast—and the current policy debate—would suggest.

A. The treatment of retirement trust funds

No financially responsible firm would consider its pension reserves as a source of financing for current operating expenses. Neither should the federal government. This simple but fiscally prudent observation has a significant impact on estimates of the available surplus.

As noted above, a substantial portion of currently project budget surpluses over the next 10 years occurs because the Social Security trust fund will take in about $2.5 trillion more in payroll tax revenues and interest received on its assets than it will pay out in benefits and administrative costs. Leaders of both political parties agree that accruing Social Security trust fund balances should contribute to improving that program’s long-term financial viability, and should not be used to finance tax cuts or other spending programs.

Medicare pays for health care for the elderly, and is divided into two parts. Part A, hospital insurance, covers hospital costs and is financed by payroll taxes. Part A is very similar in structure to social security. Workers contribute payroll taxes to a trust fund while working and receive promised benefits when they are elderly. Part B, supplementary medical insurance, is financed by a combination of user fees and general revenues. Over the next 10 years, the Medicare (Part A) trust fund is projected to run surpluses totaling $392 billion (CBO 2001, p.

19). Although Medicare is officially part of the on-budget surplus, both Houses of Congress voted last year to support measures that protected the Medicare trust fund from being used to finance other programs or tax cuts. The House of Representatives approved the measure by a vote of 420-2. The Senate passed two separate measures; 98 Senators voted in favor of one or both. The strong votes demonstrated overwhelming Congressional support for preserving the Medicare trust fund. In 2001, the House again has voted overwhelmingly to protect Medicare surpluses.

While the social security and Medicare trust funds have received significant attention in the budget debate, a third set of retirement funds has not. Trust funds holding pension reserves for federal military and civilian employees will accrue surpluses of $419 billion over the next 10 years (CBO 2001, p. 19). Under current budget procedures, these surpluses are a component of the on-budget surplus. Like Social Security and Medicare, however, these trust funds represent current accumulations intended to provide retirement benefits to future workers. Thus, the same economic logic that has led fiscally responsible leaders to protect Social Security and Medicare balances, implies that government pension reserves should be protected as well. Many states, in fact, already separate their pension reserves from funds available for tax cuts and other spending. A recent proposal (H. RES. 23) by Representatives Baron Hill (D-Indiana) and Gene Taylor (D-Mississippi) would protect the pension reserves owed to military workers. Fiscal responsibility requires that the same protections be accorded to civilian pensions as well.

B. The definition of current policy

In order to project future spending and tax revenues, assumptions must be made about how tax and spending programs will evolve. The CBO's baseline forecast is intended only to measure the implications of maintaining "current policy." But how one should project current policy into the future is not always obvious. The baseline forecasts project current policy subject to a variety of statutory requirements, which limit the scope of the forecast's underlying assumptions and time horizons and can be at variance with reasonable expectations.

Mandatory spending—e.g., entitlements, such as Social Security—is generally assumed to continue as it is currently structured in the law. Discretionary spending, however, poses problems with regard to defining "current policy." Unlike mandatory spending, discretionary programs—e.g., defense, education, the environment, or infrastructure—are not automatically included in the annual budget and thus require annual appropriations from Congress. As a result, no consensus exists about how to project current policy for discretionary programs. In light of this quandary, CBO simply assumes that real discretionary spending authority will remain constant at fiscal year 2001 levels (CBO 2001, p. 76).

This assumption is clear, but may not be very reasonable. Discretionary spending totaled 6.3 percent of GDP in 1999 and 2000, the lowest share since at least 1962. Under CBO's baseline forecast, discretionary spending would fall to 5.1 percent of GDP. That is, it would fall by 20 percent relative to the size of the economy. It would also fall by over 10 percent in per capita terms. In a growing economy with large surpluses, growing defense needs, and other concerns, this seems to be a particularly draconian baseline.

At the very least, it would be more reasonable to have real discretionary spending grow at the same rate as the population (about 1 percent per year). This would hold real discretionary spending per person constant, but would still allow spending to fall to 5.6 percent of GDP by 2011. Incorporating this baseline would raise discretionary spending by $359 billion (CBO 2001, table 4-4) and, counting the added interest payments on federal debt that would be required, would reduce available surpluses by about $418 billion.[1]

A more ambitious alternative baseline would have discretionary spending grow at the same rate as nominal GDP, thus keeping the ratio of discretionary spending to GDP constant. This would raise spending by $905 billion (CBO 2001, table 4-4) and reduce the available surplus by $1,055 billion between 2002 and 2011.

To put these figures in perspectives, note that in the campaign President Bush proposed new spending programs totaling $475 billion, along with cuts in government spending of $196 billion, for a net spending increase of $279 billion between 2001 and 2010 (table 1). This is virtually identical to the cost of having real discretionary spending grow by 1 percent over the same period (rather than over 2002-2011, see CBO table 4-4). Thus, this suggests that having real discretionary spending grow by 1 percent is a lower bound for the likely path of discretionary spending, both because Congressional Democrats and Republicans may have proposals of their own sometime over the next 10 years, and because President Bush may have more proposals for spending—especially on defense—after his initial round of proposals.

At least two aspects of current policy toward taxation merit consideration. The first regards the alternative minimum tax (AMT), one of the most complex areas of individual tax law. The AMT was implemented as a sort of backstop confronting the small number of taxpayers who are considered to be too aggressive in creating shelters and claiming deductions to avoid paying taxes.

In practice, the AMT has affected few taxpayers. In 2000, for example, about 2 million taxpayers faced the levy. Under current law, however, the Treasury projects that by 2011, 21 million taxpayers will be affected by the AMT. The main reason why is that the AMT exemption is not indexed for inflation. CBO's surplus forecasts assume that the dramatic rise in AMT taxpayers will occur. However, the increase would be fought fiercely by the affected groups. Indeed, the problem has already received significant attention, even though only a small portion of taxpayers currently face the tax.

"Current policy" would be better represented by indexing the AMT for inflation. This would keep the number of taxpayers on the AMT limited to about 1.9 percent by 2010. The lost

[1]Interest payments are estimated by assuming the federal government pays an average of the 3-month rate and the 10-year rate on outstanding debt (CBO 2001, table E-2), that half of the increased expenditures in a given year accrue interest costs during that year, and all of the increased expenditures in a given year accrue interest costs in future years.

tax revenue from this policy would total $113 billion over the next 10 years. Counting the added interest, the net cost would be $130 billion.[2]

A second tax issue relates to temporary tax provisions, a number of which are scheduled to expire over the next decade. For all taxes other than excise taxes dedicated to trust funds, CBO assumes that legislated expirations occur as scheduled. In the past, however, the temporary provisions have typically been extended another few years each time the expiration dates approached. In light of this practice, current policy is more aptly viewed as assuming that these so-called “extenders” will be granted a continuance. Extending the provisions—except the one relating to AMT, which is addressed above—through the 10-year horizon would cost a net of $69 billion in lost revenues (CBO 2001, table 3-12), plus an estimated additional $13 billion in interest costs.

C. Implications for the available surplus over the next 10 years

Table 2 shows that these adjustments have a profound effect on the amount of funds that should be considered to be available for tax cuts or new spending. (Appendix table 1 provides year-by-year estimates of the alternative surplus measures.) The total 10-year projected surplus of $5.6 trillion is shown in the first line. Removing the social security trust fund surplus generates an “on-budget” surplus of $3.1 trillion. Removing Medicare trust funds reduces the surplus to $2.7 trillion. Protecting government pension funds from invasion for other purposes reduces the available surpluses to $2.3 trillion. That is, almost 60 percent of the projected 10-year surpluses are due to the retirement trust funds.

Adjusting for the issues regarding the AMT and expiring tax provisions reduces the available surplus to $2.1 trillion. If real discretionary spending were held constant on a per capita basis—or if President Bush’s spending plans were implemented—the net available surplus for other programs would be just under $1.7 trillion. In contrast, if discretionary spending were held constant as a share of GDP, the remaining available surplus would be about $1 trillion (table 3).

Thus, depending on what is considered the most reasonable assumption regarding current policy toward discretionary spending, the available surplus is between $1.0 trillion and $1.7 trillion. This represents between 18 and 30 percent of the total surplus, and roughly one-third to one-half of the on-budget surplus over the 10 year period. The Center on Budget and Policy Priorities (CBPP) has made a similar set of adjustments and estimated an available surplus of about $2 trillion over the next 10 years (Greenstein and Kogan 2001).[3]

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[2] Estimates of the revenue loss from indexing the AMT from 2002 to 2010 are taken from Rebelein and Tempalski (2000). The estimates rise steadily and reach $18 billion by 2009, and $24 billion by 2010. I extrapolate the 2011 revenue loss to be $30 billion.

[3] The CBPP estimates differ from the estimates presented here in a number of ways. CBPP focuses on holding discretionary spending per capita constant, does not adjust for government pension reserves, and includes adjustments for some other programs, such as farm spending. The differences between the CBPP estimates and the ones presented above, however, are small relative to their similarities: both studies make the case that the surplus available for new spending programs or tax cuts is much less than it appears to be, based on the baseline forecast.

D. Looking beyond the 10-year horizon

There is nothing sacrosanct about a 10-year planning horizon. For public policies such as social security and medicare, the official planning horizon is 75 years. Indeed, an analysis of social security's finances that focused only on the next 10 years would not pass a laugh test. Likewise, many important private economic decisions, such as how an investor values a firm's stock, or how a family sets the parameters of a financial plan, also typically depend on perceptions of events that will occur more than 10 years into the future. Looking beyond the 10-year horizon is particularly important for assessing the budget outlook because the rapid growth in entitlement programs driven by an aging population and rapidly rising medical care expenditures is not projected to begin until later dates.[4]

To take these and other factors into account, previous research (Auerbach 1994 and 1997, Auerbach and Gale 1999, 2000) estimates the long-term "fiscal gap" under different policies. The fiscal gap is the size of the permanent increase in taxes or reductions in non-interest expenditures (as a constant share of GDP) that would be required *now* to keep the long-run ratio of government debt to GDP at its current level. The fiscal gap gives a sense of the *current* budgetary status of the government, taking into account long-term influences.

These estimates use the current CBO 10-year forecast through 2011 and CBO long-term budget forecasts through 2070. In subsequent time periods, all revenues and non-interest expenditures are assumed to remain a constant share of GDP. Social Security and Medicare outlays follow the intermediate projections in the reports released by the trustees of the funds. Discretionary spending, federal consumption of goods and services, and all other government programs, with the exception of net interest, are assumed to grow with GDP after 2010. Tax revenues are a constant share of GDP, except for supplementary medical insurance premiums collected for Medicare, which grow relative to GDP.

Table 4 shows that different measures of current policy can have a significant impact on the long-term fiscal status of the federal government, if these policies establish levels of spending or taxes that are preserved (relative to GDP) after 2011.[5] Under the CBO baseline assumptions about discretionary spending, the fiscal gap through 2070 is projected to be 0.67 percent. That implies that a permanent tax increase of 0.67 percent of GDP, which would currently be about $67 billion, would be required to restore fiscal balance through 2070. The fiscal balance on a permanent basis is currently 3.33 percent of GDP. Allowing discretionary spending outlays to remain constant as a share of GDP raises the fiscal gap further, to 1.45 percent of GDP over the next 70 years and 4.14 percent on a permanent basis.

In light of the recent political pressure to raise spending and/or cut taxes, it seems highly unlikely that there will be any immediate action to reduce the fiscal gap. But delaying the

[4] Although CBO is the source of the 10-year baseline forecast, CBO itself warns several times of the dangers of ignoring the longer-term situation (see CBO 2001, p. xiv and pp. 4-5) and in fact regularly publishes estimates of the federal government's long-term fiscal status (see CBO 2000). David Walker, head of the General Accounting Office, also testified recently on the importance of the taking the long-term budget picture into account.

[5] I thank Alan Auerbach for providing the estimates in table 4.

implementation of necessary tax increases or spending cuts will raise the required fiscal correction at the time of implementation.

All of the calculations above show that systematically incorporating longer horizons implies that the government faces significant financial shortfalls. This, of course, significantly damages the case for large-scale tax cuts today. Remarkably, however, some tax cut advocates try to use horizons (slightly) longer than 10 years to justify large tax cuts. They argue that when the 10-year projection period changes next year to 2003 to 2012 (from the current 2002 to 2011), the 10-year projected surplus will rise dramatically because adding the surplus projected for 2012 will far outweigh the loss of the surplus projected for 2002. Their claim is correct as far as it goes, but is misleading. It is essentially arguing for an 11-year perspective, which completely ignores the long-term fiscal shortfall.

E. Uncertainty

It is difficult to predict the course of the economy over a period as short as 6 to 9 months. Thus, it should not be surprising that all of the estimates above are subject to a considerable amount of uncertainty. A few comments on the uncertainty of the forecasts are warranted.

First, CBO's underlying economic assumptions do not appear to be unreasonable. Their forecast for GDP growth over the next two years—2.4 percent in 2001 and 3.4 percent in 2002—is in the middle of the Blue Chip forecasters. Notably, CBO does not foresee a recession in 2001, just a slowdown. Just as notably, CBO projects that the economy will turn around and growth will accelerate in 2002, even without any changes in tax or spending policy. CBO predicts a growth rate of about 3.1 percent for the rest of the decade, which does not seem out of line with reasonable expectations. CBO (2001, p. 60) points out that its forecast does not depend on a continuation of high capital gains revenues or high stock market values and in fact projects a decline in the share of revenues from capital gains.

Second, there is simply a huge amount of uncertainty regarding the evolution of the economy and the surplus. CBO (2001, p. 99) reports optimistic and pessimistic scenarios for the economy, where the 10-year surpluses range from $8.8 trillion to $1.6 trillion. In the latter case, there is an on-budget deficit of about $525 billion over the 10 years. CBO (2001, p. 96) also notes that on average their revenue forecast has been off by 11 percent of revenues after 4 years. If revenues were 11 percent higher or lower than forecast over the next 10 years, the surplus would differ from baseline by about $3.9 trillion. Interestingly, CBO (2001, p. 102) estimates that a mild recession followed by higher-than-trend growth would have little effect on the 10-year surplus, but that does not preclude a deeper, longer recession or a change in the long-term growth rate from having a significant impact.

Third, an important source of uncertainty stems from the fact that the surpluses are expected to rise over time. Only 12 percent of the projected total surplus and 10 percent of the projected on-budget surplus occurs in the first two years. Likewise, only 36 percent of the projected total surplus and 32 percent of the projected on-budget surplus occur in the first five years.

Fourth, other things equal, long-term estimates are inherently more uncertain than short-term estimates. But the added uncertainty should not lead us to ignore long-term issues, for at least two reasons. First, the serious consequences of a relatively bad long-term outcome should spur a precautionary response from policymakers now (Auerbach and Hassett 2000). Second, over the next 10 years, the primary factor affecting surpluses will be the course of the economy, which as noted above, is uncertain. In contrast, in the longer-term, the demographic pressures that are due to an aging population are far more certain to occur.

F. Implications for the tax policy debate

These findings suggest some useful lessons for the current debate about how to allocate the surplus. The virtually exclusive emphasis given to baseline 10-year budget projections in current fiscal policy debates is inappropriate. The baseline forecast suggests the availability of trillions of dollars for tax cuts or new spending, but is based on a particular set of views of what constitutes current policy. Fiscal responsibility and plausible notions of current policy reduce the available 10-year surplus to between $1.0 and $1.7 trillion.

Despite the recent strong improvement in the government's fiscal position, there is still a long-term imbalance. This imbalance is a "future" problem only insofar as our budget accounting rules ignore the existence of liabilities already accrued.

Given this long-term imbalance, the fiscal climate may be more troubling now than in previous years. The short-term surplus and the decline in the long-term fiscal gap are no doubt improvements, but fiscal discipline may be especially difficult to impose under current conditions. In the 1980s and early 1990s, when the country faced both short-term and long-term deficits, the short-term deficits helped focus attention in a way that also helped reduce long-term gaps. Today, the United States faces the same trade-off between current and future generations as in earlier decades, and it is still confronting a long-term shortfall. But the current policy discussion focuses on ways to use the surplus that would likely exacerbate the long-term situation.

2. President Bush's Budget and Tax Proposals

President Bush's budget predicts a baseline surplus of about $5.6 trillion, a non-social security surplus of $3.0 trillion, and a non-medicare, non-social security surplus of $2.5 trillion. While these numbers are reassuringly similar to the CBO figures, the budget departs from fiscally responsible actions in three main ways.

The first concerns the social security trust fund. Normally, trust fund surpluses are used to add to government saving, by paying down the debt. The President, however, would divert $600 billion of social security trust fund surpluses from debt repayment into a "reserve fund." The Administration argues that it cannot use those surpluses to finance debt repayment because there will not be enough purchasable government debt outstanding. An alternative (discussed below) would be to purchase private assets with the funds, but the Administration claims to be philosophically opposed to such a view (even though the state of Texas holds $21 billion in private assets as part of pension fund for government workers). The "reserve fund" is the only alternative left, according to the Administration. However, the amount of available debt to be repurchased is controversial and CBO and Fed Chairman Alan Greenspan both suggest that the relevant amount that can be repurchased is hundreds of billions of dollars larger than the Administration claims. Moreover, if those funds are placed in the "reserve fund" they are not being used to protect the social security surplus and thus represent a violation of the virtually unanimous agreement in both Houses of Congress to protect those funds.

The second fiscally irresponsible act involves siphoning off the Medicare trust fund surplus to pay for the rest of Medicare. Medicare part A is financed by payroll taxes and is currently running a cash flow surplus. That surplus, however, is nowhere near sufficient to finance future Medicare part A payments—the part A system as a whole is in long-term deficit. That is why it is important not only to save the part A surplus, but to supplement that surplus with additional funds over the years. The Administration goes in exactly the opposite direction. Not only does it make no effort to fund the long-term deficit in Medicare part A, it also takes away the surplus in part A by spending the funds on current supplemental medical insurance for the elderly. This is a gross violation of the use of the Medicare surplus, and flies in the face of efforts of responsible members of Congress from both parties who have tried to protect the fund.

The third fiscally irresponsible act is the President's tax proposal. The proposal contains several major elements, and is phased in gradually over time (Bush-Cheney 2000, JCT 2000a). The most important elements, listed in order of their revenue cost when fully phased in, are:

--Reduce the highest income tax rates

> By 2006, tax rates in the 39.6 and 36 percent brackets would fall to 33 percent, and rates in the 31 and 28 percent brackets would fall to 25 percent.

--Abolish the estate tax

> The estate tax would be reduced gradually and then abolished in 2009. It is unclear whether any changes in the taxation of capital gains at death would occur.

--Create a new 10 percent tax bracket

> The first $6,000 of taxable income for singles and $12,000 for married couples would be taxed at 10 percent rather than 15 percent.

--Expand the child credit to high-income households, reduce the phase-out rate, and double the credit amount.

> Eligibility for the full credit would be extended to all taxpayers with income below $200,000 (up from $110,000 for married couples and $75,000 for singles, currently), the phaseout rate would fall from 5 percent to 2 percent, and credit would double to $1,000. The credit would remain non-refundable.

--Allow a two-earner deduction

> Allow a 10 percent deduction for the earnings of the lower-earning spouse in a two-earner family. The maximum deduction would start at $12,000 in 2002 and rise to $30,000 in 2005.

Other components include allowing a charitable contributions deduction for households that do not itemize, allowing individuals aged 55 and over to make penalty-free withdrawals from their IRAs to make charitable contributions, raising the cap on corporate charitable contributions from 10 percent to 15 percent of taxable income, expanding the limits and uses of educational IRAs, and permanently extending the credit for research and development.

Recently, HR 3 included the creation of a new bracket and the reduction in the marginal tax rates, with the latter accelerated one year. The Joint Committee on Taxation has estimated that if HR 3 were enacted, approximately 36 million taxpayers would face, or be affected by, the AMT by 2011. This is 15 million more than the 21 million that would be placed under the AMT under current law. The Bush administration has acknowledged that the AMT creates a problem for the proposed tax cut . Indeed, the tax program on the Bush campaign web site (where voters could calculate how much of a tax cut they would receive under Bush's plan) did not allow for the AMT to reduce anyone's tax cut, and thus implicitly assumed that an AMT fix was a *de facto* part of the Bush plan. For all of these reasons, I include the necessary AMT adjustments as part of the Bush plan. To be clear, these adjustments would merely undo the increase in AMT taxpayers due to the Bush plan. They would not address the increase in AMT taxpayers that is expected to occur under current law even in the absence of tax changes.

3. Evaluating the President's Tax Proposals

The justifications for a tax cut are a crucial part of the proposal, for at least two reasons. First, the goals themselves might be criticized. For example, trying to use a tax cut to prevent the economy from falling into a recession may not be an achievable goal, and thus may not be worth pursuing. Second, the goals may be laudable, but proposed tax cuts might not achieve the goals very effectively. For example, fighting a current recession with a tax cut that is substantially delayed would not be very effective.

More generally, different justifications naturally lead to consideration of different policies, and the appropriate size, timing, and distribution of tax cuts depends on the justifications put forth. The justification given must pass two tests: it must justify a tax cut in general, and it must justify the particular cut that is being proposed.

In practice, the Administration has had a very difficult time providing a coherent justification for its tax package. The President's justifications for his tax proposal have changed markedly over time, though the proposal itself has not. Most recently, the goals appear to include: to provide a fairer distribution of tax burdens, to improve access to the middle class, to reduce the marriage penalty, to stimulate the economy, and to reduce the high tax burdens on families (White House Press Office 2001). In this section, I evaluate the President's plan along these and other criteria.

A. <u>Size of the tax cut</u>

Interestingly, "maintaining fiscal discipline" is not usually stated as a goal of the President's tax plan, and it is easy to see why. Table 5 breaks down the costs into three components. (Year-by-year and provision-by-provision estimates are provided in Appendix Table 2). The provisions of HR 3 would reduce taxes by $958 billion over the next 10 years. Other components of the plan the President submitted to the Congress on February 8 would cost $717 billion. Additions to the plan that were in the President's budget, but not in the earlier submission to Congress cost another $127 billion. The adjustments required to avoid having taxpayers bear the burden of the AMT because of Bush's tax cuts would total $292 billion. The added interest payments on the federal debt caused by the reduction in federal revenues would cost another $418 billion. Thus, although the proposal is often referred to as a $1.6 trillion tax cut, the real cost of the proposal now comes to an astonishing $2.5 trillion over the next 10 years.

Note also that these figures <u>underestimate</u> the cost because some of the estimates are based on JCT estimates from May 2000. Projected revenues in the January 2001 CBO baseline are about 9 percent, or $2 trillion, higher than in the January, 2000 baseline. If the revenue effects were estimated from the current revenue base, they would be larger.

Ultimately, assessments of whether the Bush's proposed tax cut is too large are in "the eyes of the beholder." Several analytic perspectives, however, suggest the tax cut is excessive. First, the magnitude of the tax cut exceeds the "available surplus" listed in tables 2 and 3 by between $800 billion and $1.5 trillion. Thus, enacting Bush's tax cut would imply that no other important policy priorities could not be met unless Congress is willing to finance the programs with balances in the retirement trust funds. The Bush tax cut is exactly equal in size to the Bush administration's non-medicare, non-social security surplus.

Some have claimed that economic responses to the tax cut would reduce the costs by one-quarter. However, these economic responses leave out the reduction in national saving that would occur along with the cut in tax rates. The reduction in national saving would reduce productivity growth and place a drag on economic growth. Analysis by Peter Orszag for the Center for Budget and Policy Priorities suggests that the decline in national saving would reduce revenue by about as much as the improved incentives have been claimed to raise revenue. Hence, the net effect would be roughly a wash.

Third, the proposed tax cut would substantially increase the long-term fiscal gap listed in table 3. Even if discretionary spending were held constant in real terms, so that it fell continuously as a share of GDP, Bush's tax cut would triple the long-term fiscal gap through 2070 and raise it by 150 percent on a permanent basis. This would significantly worsen the long-term fiscal problem the government faces. This should not be surprising. By 2011, the Bush tax cut, including the AMT adjustment, would reduce income tax revenues by over 16 percent on a permanent basis.

Some tax cut advocates have asserted recently that Bush's proposals are smaller than the 1981 tax cut signed by President Reagan. This claim is misleading. When evaluated on an equivalent basis, the two plans are about the same size. Several adjustments are needed to make evaluate the plans on an equivalent basis, though. Reagan's tax cut has been estimated by the CBO (1983) and the Treasury (Tempalski 1998) to have reduced revenues by between 4.2 percent and 5.6 percent of GDP. However, recall that the tax system was not indexed for inflation in 1981. CBO (1983) estimates that at least 40 percent of the Reagan tax cut was simply an elimination of tax increases that would have occurred because of inflation. In addition, as soon as the 1981 act was passed, politicians on both sides of the aisle recognized that the tax cut was too large and moved to raise taxes in 1982 by about 1.2 percent of GDP. Adjusting for these two factors places the Reagan cut at between 1.3 percent and 2.1 percent of GDP (Orszag 2001).

Bush's proposed tax cut, of course, would occur above and beyond the inflation indexing that will automatically occur over the next decade. Bush's tax cut is phased in slowly over time and the costs are heavily backloaded. Table 5 shows that about three-quarters of the costs occur in the second five years of the forecast period. Thus, estimates of the cost of the plan relative to GDP over the 10 year period are misleading. In 2009., when the plan is fully phased in, the cost of the tax cut and the accompanying AMT adjustments is estimated at 1.7 percent of GDP. Note that this places the costs exactly in the middle of the range of the costs of the Reagan plan.

Moreover, the case for tax cuts is much weaker currently than it was in 1981. The 1981 tax act reduced the top rate from 70 percent to 50 percent, which is higher than the top rate is today. Also, Treasury data show that in 1981, income tax burdens for families of four with half-median, median and double-median income were the highest they have been in any year since 1955 (Lerman 1998). Income tax burdens had risen for five years in a row for the low-income family, the previous 7 years for the median income family, and the previous 10 years in a row for the high-income family. As of 1999, the low-income family's tax burden is 7 percentage points lower than it was in 1981, the median income family's burden is 4 percentage points lower than it was in 1981, and the high-income family's tax burden had fallen by 5 percentage points as well. Congressional Budget Office (1999) data show that for families in all five income quintiles, income tax burdens in 1981 were higher than they are today and in almost all other years.

B. Distributional effects

The allocation across income groups of the tax cuts proposed by President Bush has proven controversial. The main reason why is that during the campaign and since the Inauguration, the Administration has launched a non-stop campaign of tortured logic, misleading examples, and outright false characterizations of the plan. The main results are clear: by any reasonable standard, the plan provides disproportionate benefits to high-income households. But the Adminstration's efforts to obfuscate this point have confused a significant number of commentators and are worth exploring carefully.

The administration (White House 2001, p. 1) characterizes the tax plan as follows:

(i) "The highest percentage cuts go to the lowest income Americans"

(ii) “Lower income taxes for all”

(iii) “Everyone who pays income taxes benefits”

(iv) “The greatest help for those most in need”

(v) “The typical American family of four will be able to keep $1,600 more of their own money.”

The Administration likes to focus on two aspects of their tax cut, each of which is extremely misleading in understanding the progressivity of the cut. First, they claim the plan benefits the lowest income Americans most because it gives them the highest percentage cut in income taxes. Second, the Administration notes that under its plan, high-income households would pay a larger share of income taxes than they currently do.

First, the Administration apparently defines “the lowest income Americans” as those with income of $22,000 or higher. In fact, more than 40 million tax units have income below that figure. Second, the income tax for the family of four with $26,000 in 2001 is only $20 per year, so their 100 percent reduction in income taxes raises their after-tax income by trivial amounts (Greenstein 2001, Greenstein and Shapiro 2001).

More generally, there are many ways to report the size of tax cuts, but the percentage reduction in one particular tax or the percentage share a particular tax—which the Administration has chosen to emphasize--is very misleading. To see why, examine table 6, which works through these issues in a hypothetical example. In the current system, a waitress earns $22,000 pays $72 in income taxes (after the child credit and before the EITC) and $3,366 in payroll taxes. The payroll tax includes both the employer and employee share since most economists believe that payroll taxes are passed on to workers in the form of lower wages. A lawyer earns $200,000 and pays $48, 612 in income taxes and $15, 250 in payroll taxes.

The Bush tax cut would reduce the waitress’ income tax by $72 and the lawyer’s by $8,4,13. Who gets the bigger tax cut? The administration would say the waitress did. Her tax cut is a larger share of her <u>income tax</u>, and she pays a smaller share of income taxes after the tax than before.

However, most reasonable observers would likely conclude that the lawyer got the larger cut. After all, the lawyer had a bigger percentage decline in the sum of payroll and income taxes, a bigger percentage increase in after-payroll-and-income-tax wages, and, most importantly, a larger percentage increase in after-tax income. Needless to say, the lawyer also received a tax cut that in absolute terms is gigantic compared to the waitress’s tax cut. Indeed, the lawyer’s tax cut is equal to 4.5 months of earnings for the waitress, yet the Administration claims that the attorney gets the worse part of the deal!

It is important in these comparisons to emphasize total taxes, rather than just income taxes, because policy makers could choose to cut any of a variety of taxes and it is the overall impact of the tax cut that matters, not just how one tax is affected.

Table 7 shows the estimated distributional impact of Bush tax cut proposal. As in the hypothetical example, taxpayers in higher income brackets receive a larger percentage reduction in <u>total</u> federal taxes, a larger percentage increase in after-tax income, and a much larger tax cut in absolute terms. These figures demonstrate that the largest benefits under the Bush proposal go to high income households.

The administration notes that everyone who pays income taxes will benefit. However, there are many households that pay substantial amounts of payroll taxes, but not income taxes, who would not benefit. If the goal is to provide help for those most in need, it is unclear why the beneficiaries should be limited to income tax payers. For example, table 7 shows that 75 percent of tax filing units in the bottom 20 percent of the income distribution and 37 percent in the next quintile receive <u>no</u> benefit from the tax cut proposal. This shows that it is simply false to claim that "the greatest help goes to those who are most in need."

Table 7 also shows that 89 percent of all tax filing units, including 95 percent of those in the bottom 80 percent of the income distribution, would receive less than $1,600 in tax cuts when the cuts were fully phased in. Thus, it may be that some typical family defined by some metric receives $1,600, but the overwhelming majority of households will receive less, and 27 percent will receive no tax cut at all (CTJ 2001).

A common, and reasonable, response to complaints that high-income taxpayers receive a large share of proposed tax cuts is that high income taxpayer pay a large share of existing taxes. However, under the Bush plan, households in the top 1 percent would receive tax cuts that are far in excess of the proportion of taxes they pay. Table 8 shows that the top 1 percent paid about 21 percent of total federal taxes in 1999, but under the Bush plan, they would receive at least 35 percent of the tax cut. Under other estimates, not shown in the table, they would receive as much as 43 percent of the cut.

Finally, the administration trumpets its expanded child credit as helping families with children. But one study found that 82 percent of the benefit of the expanded child credit would go to households in the top 40 percent of the income distribution. Moreover, about one-third of all children live in families with incomes too low to receive any benefit from the credit. (Shapiro, Dupree and Sly 2001).

<u>C. Tollbooth to the middle class</u>

The President's proposal attempts to reduce what he calls the "tollbooth" to the middle class, that is, the high effective marginal tax rates that working families face. The effective marginal tax rate varies as a function of income level and is a combination of federal and state income taxes, payroll taxes, and the phase-outs of various programs. However, it is well known that the highest effective marginal tax rates are faced by those earning less than $20,000. The President's proposal does not address these problems at all. As Shapiro et al (2001) note, expanding the EITC would help both this group and the higher-income group (in the mid $20,000s) that Bush's proposal is aimed to assist. In addition, there is little econometric evidence that the high effective marginal tax rates created, for example, by the EITC, actually reduce labor supply.

D. Marriage penalty

Bush's proposal to address the marriage penalty is to restore a second-earner deduction that was in place between 1981 and 1986. When fully phased in, the two-earner deduction would allow up to $30,000 of the earnings of the lower-earning spouse to be deducted from income. This would reduce the marriage penalty for two-earner families, who are the ones most likely to face such penalties. However, the proposal is poorly targeted in two ways. First, it would enlarge the marriage subsidies that already exist for many couples. Second, it would provide no benefits for lower income households. This is important both on distributional grounds and because the EITC imposes some hefty marriage penalties.

E. Tax Cuts and a Recession

One of the most puzzling and misleading aspects of the President's defense of the tax cut is his claim that it would be an effective way to fight a brewing recession. First, whether there is a recession or simply a slowdown in the growth rate is unclear. Second, almost all economists, including top Bush economic advisers Larry Lindsey and John Taylor, have argued that tax policy is a difficult way to fine tune the economy (See Lindsey 1999, pp 28-9 and Taylor 2000, p. 27). Tax laws have to be drafted, debated, passed, reconciled, signed and implemented. Counter-cyclical tax cuts could also make the Federal Reserve Board's job more difficult by adding a new element of uncertainty. In contrast, the Federal Reserve Board can cut interest rates quickly and decisively to stimulate the economy.

But even if there is a recession, and even if tax cuts could in general fight recessions effectively, the President's tax proposal is incredibly poorly designed to fight a recession that is happening currently. For starters, there is simply no tax cut proposed for fiscal 2001 (which ends on September 30, 2001). It is hard to see how a tax cut could boost the economy now if it is not providing any tax cuts now. In addition, the President's plan would only provide tax cuts of $21 billion (about $75 per person or 0.2 percent of GDP) in fiscal 2002. Thus, in the next 18 months, the plan would provide virtually no stimulus at all.

In addition, an anti-recession plan should put money in the hands of low- and middle-income households. These are the people who are most likely to lose their jobs in a recession, and the ones for whom tax cuts would give the biggest bang for the buck in stimulating the economy. In contrast, the President's plan gives the vast bulk of funds to high-income households, as shown above.

Finally, an anti-recession tax package should be small enough not to raise interest rates. However, tax cuts that would use up more than $2 trillion of surpluses during the next 10 years could well lead to higher interest rates. Note that this would actually be counterproductive to fighting a recession, so that the plan could make matters worse. Nor does a plan that grows in costs over time make sense as an anti-recessionary device. Recessions are temporary. We do not need to cut taxes by $1.1 trillion between 2007 and 2011, as Bush's plan would, to stave off a recession in 2001.

Bush supports the idea of making the tax cuts immediate, but his proposal does not contain such a feature. Moreover, accelerating his package would provide few benefits but would create significant problems. It would only give the economy a tiny stimulus ($21 billion) in fiscal 2001, and so would do little to help fight a recession directly. And it might indirectly hurt the economy. My own estimates, based on JCT data, and a similar analysis by Greenstein (2001) show that accelerating the plan would raise the 10-year cost by $400 billion. This would further crowd out other spending priorities and would likely put increased pressure on interest rates. The net effect could be to make the economy less productive in the short run. And, of course, accelerating the package would not change the distributional effects.

F. Are Americans Overtaxed?

Another argument the president uses to justify tax cuts is that tax revenues are at historic highs and therefore that Americans are being crushed by overburdensome taxes. The first claim is right. Federal tax revenues were 20.6 percent of GDP in 2000, the highest peacetime level ever. Note, however, that this total includes all federal taxes, not just income taxes. Thus, if a high aggregate federal tax burden justifies tax cuts, it should justify cuts in a variety of taxes, not just the income and estate taxes.

However, even granted that total revenues are high, it is not true that most households are bearing higher tax burdens than they would have with the same income in the past. In fact, for most families, taxes are as low or lower than they have been in the past 20-30 years. Overall tax payments have risen because the rich have gotten richer at an impressive rate and because they have faced higher tax rates due to policy changes in 1990 and 1993. This distinction between what is happening to most households and what is happening at the aggregate level is crucial to the debate. Tax cut advocates typically prefer to focus on the aggregate numbers. But even the Wall Street Journal editorial board, a staunch supporter of tax cuts, has acknowledged recently that "taxes on a typical middle income family have fallen to their lowest level in more than 20 year" (Wall Street Journal 2001).

A Department of Treasury study (Lerman 1998), using a methodology that has not changed over the course of several Administrations, shows that across a wide range of income levels, federal income taxes as a share of earnings are down. A four-person family with earnings of about $55,000 paid 7.5 percent of that amount in federal income taxes in 1999, the lowest rate since 1966. For families with earnings half as large, the 1999 income tax rate was the lowest since 1955, when the estimates begin. Families with earnings of almost $110,000, who are squarely in the top 10 percent of the income distribution, the 1999 income tax burden of 14.1 percent was the lowest rate since 1972 (see figure 1). Adding social security and medicare taxes to the Treasury income tax estimates raises the estimated tax burden, but does not change the conclusion that taxes are low relative to previous years (see figure 2).

Congressional Budget Office (1999) estimates show that, for households in the bottom 40 percent of the income distribution, the burden of all federal taxes is at a twenty-year low (see figure 3). For households in the 40^{th} to 80^{th} percentile, federal taxes are at approximately the average share that they have been in the past. Only among the top 20 percent of households did total federal taxes rise in the last 15 years. Notably, those households received the largest cuts in

1981, as shown in figure 3, and despite the increase in their average tax burden, their after-tax income has increased faster than income in any other quintile (see figure 4). The after-tax income of high-income households rose particularly fast between 1995 and 2000. Thus, their tax burden rose primarily because their incomes rose so much and the U.S. has a progressive tax system.

American tax burdens are also low compared with those in other industrialized countries. Among the 20 largest OECD countries in 1996, the U.S. had the lowest ratio of taxes to gross domestic product.

Ultimately, whether Americans are overtaxed is a judgment call. The measure of appropriate tax levels depends on many factors, including an analysis of how the money is used. But the evidence speaks clearly: the vast majority of American families forfeit the same or smaller share of their income to taxes today than they would have in the past with the same income, and those that forfeit more have generally experienced huge income gains in the past decade.

G. Are tax cuts needed because government would waste any surplus funds?

Another set of arguments claims that we need tax cuts because surpluses lead to bloated government spending. There is certainly an element of truth to this characterization of the problem. For example, Congress exceeded the spending caps by increasing amounts in each of the past three years. However, the vast portions of existing surpluses have been allowed to accumulate, so the argument is weakened considerably.

Moreover, it is especially inappropriate for defenders of the Bush administration's tax cut to make this argument, for several reasons. First, President Bush himself has proposed about $500 billion in new spending programs over the next decade (see table 1). The President clearly believes that not all government spending is wasteful. Second, reforming social security and medicare and increasing defense spending, as the President has indicated he would like to do, will cost additional funds. Third, while both Houses of Congress have voted to protect Medicare surpluses from being used for other purposes, it is the White House that is currently resisting this effort.

Finally, even if this argument justifies a tax cut, it does not provide a rationale for why the tax cut should be focused on the highest-income households.

H. Paying off the debt would force the government to invest in private assets

An argument put forth recently by Alan Greenspan, and quickly repeated by tax cut advocates, is that under current surplus projections, the government will pay off all available government debt by around 2006 or shortly thereafter. At that point, with more surpluses pouring in every year, the government would have to start accumulating private assets, either bonds or stocks. Greenspan and others argue that having the federal government hold such assets would raise a number of difficult issues, concerning government interference in the operation of private companies, the selection of assets to go into the government portfolio, etc.

Greenspan and others claim that it would be preferable to avoid that situation by cutting taxes now, rather than being forced either to cut taxes or raise spending massively at some point in the future or have the government invest in private assets.

Many supporters of fiscal discipline, however, recognize that these issues are important, but believe that Greenspan has overstated the problem. For example, government agencies could invest passively in index funds, in the manner of the Federal Thrift Savings Plan. Orszag (2001b) notes that state and local government pension funds have invested in private assets for a long period of time. In 2000, state and local pensions held the equivalent of 28 percent of GDP in bonds and other assets, including almost $2 trillion (equivalent in size to about 19 percent of GDP) in corporate equities. Research suggests that such funds perform relatively well (Munnell and Sunden 1999). Foreign governments also have extensive experience in private investments. Canada, Norway, and Denmark have all had favorable experiences with investment of government funds in private assets. In addition, note that giving tax cuts in order to avoid paying off the national debt will likely reduce national saving, and thereby impose a cost on future generations.

A related concern is that paying off the debt will make the market for Treasury bills and bonds evaporate. Treasuries play several important roles in financial markets—as a safe asset, a source of liquidity, an index against which other loans are priced, as a mechanism for Federal Reserve Board open market operations, etc. However, paying off government debt does not preclude the government from continuing to issue bonds. It would merely collect the funds and then reinvest them. Moreover, if the government did not issue any new bonds, fierce competition among private suppliers of debt could be expected.

In any case, how government would handle investment in private assets and how the Treasury market would respond to paying off the government debt are important questions that should be addressed. But they do not provide a justification for large tax cuts, nor do they provide a justification for tax cuts aimed at the highest-income households.

I. Are tax cuts needed because the American people are being overcharged?

President Bush and others have claimed that tax cuts are needed because Americans are being overcharged for government currently. Apparently, "overcharged" refers to the idea that current revenues exceed current outlays, under budget procedures that are in place now. Unfortunately, it is not that simple. As noted above, the government faces a long-term shortfall, not a surplus. That is, Americans have collectively promised themselves more in benefits than they have been willing to commit to in taxes. That hardly qualifies as overcharging themselves.

A related argument claims that "It is the American people's money. Give it back to them." Again, that argument is correct as far as it goes—it is the American people's money. But the long-term financial shortfall is also the American people's financial obligation.

A slightly more sophisticated version of the same argument says that if the deficits in the 1980s and early 1990s justified tax increases, then the surpluses that are currently in existence should justify tax cuts. However, in the 1980s and early 1990s, the nation faced long-term deficits and short-term deficits. The short-term deficits helped focus attention on improving the fiscal status of the government, but the real problem was the longer-term situation. Now, short-term cash-flow surpluses are obscuring the real problem, which is that we still have a long-term financial shortfall.

4. Policy Options

The current fiscal surpluses are a significant accomplishment, and should not be taken lightly or for granted. There is clearly room for a tax cut, for spending priorities, and for debt reduction. But I believe that the most important budgeting decision for the Congress is to establish a new set of budget rules, and that these rules should be established before making a significant set of tax and spending changes.

A. Budget rules

There are several reasons to develop a new set of rules. The fiscal accomplishments of the last decade should be preserved and enhanced, not squandered. The old rules are expiring. It will be more difficult to make wise choices in the absence an overall budgetary framework. And the current budget situation has dangers associated with it. The emergence of significant cash-flow surpluses over the medium term will create understandable pressures to use the funds for tax or spending initiatives. However, most of the surpluses stem from the retirement trust funds (tables 2 and 3), which prudent budgeting suggests should not be used to finance other programs, and the long-term fiscal stance is still negative (table 4).

Consideration of policy rules should take several factors into account. First, there is a certain asymmetry in policy options. It is always easier to reduce taxes later than to raise them. Second, new and unforeseen policy priorities frequently arise, so prudent fiscal management would suggest the equivalent of a "reserve fund" of some sort. Third, both budget projections and economic forecasts are subject to considerable uncertainty, which suggests another reason not to commit all available resources immediately. A set of budget rules that is consistent with these views would include the following:

-- Reaffirm the commitment not to spend social security trust funds on other programs.

-- Reaffirm the votes taken last year that protect Medicare Part A trust funds from being spent on anything other than hospital insurance. This is especially important because the Bush administration has not committed to this view.

-- Accord similar protections to the balances in trust funds for military and civilian pensions.

-- Elevate the importance of budget outcomes over longer time horizons by having CBO report its long-term forecast at the same time, and in the same document, as the 10-year Outlook that is produced every winter and the Update that is produced every summer.

-- Adopt a proposal put forth recently by Robert Reischauer, President of the Urban Institute (Reischauer 2001). Under the Reischauer rule, Congress and the President would establish a benchmark surplus measure and would only allow themselves to commit a certain percentage of projected benchmark surpluses to new spending or tax cuts, with the percentage declining over the 10-year horizon. Reischauer suggests the benchmark surplus should be the non-social security, non-medicare surplus, and that 80 percent of the benchmark surplus projected in years 1 and 2 would be available, 70 percent in years 3 and 4, and so on concluding with 40 percent of the benchmark surplus in years 9 and 10. Making this adjustment would result in a 10-year "usable" surplus of about $1.4 trillion (determined by applying the Reischauer percentages to the appropriate figures in appendix table 1). The non-retirement trust fund surplus (thus removing government pensions as well as social security and medicare) is alternative possible benchmark. In practice, this alternative definition does not make a huge difference; the available surplus would be $1.2 trillion. These proposals may not be as radical as they first appear. Last year, for example, the House passed a resolution to devote 90 percent of the coming year's surplus to debt reduction. This is merely an extreme version of the Reischauer rule.

There has also been discussion of making tax cuts or new spending programs contingent on actual budget surpluses in the previous year. The "trigger mechanism" has an admirable goal—to ensure that Congress does not promise more than it can afford. But I believe the Reischauer rule would work better, for two reasons. First, a trigger mechanism introduces uncertainty about future taxes. Second, if the goal is to ensure that tax cuts can be paid for, the trigger mechanism may fall short. A trigger mechanism would allow a tax cut in a given year, if the surplus in the previous year surpassed a target level. The problem is that the tax cut would typically be permanent (for example, if rates were cut), but the surplus may only be temporary. The fact that the surplus the previous year surpassed a target does not guarantee that surpluses in future years will be sufficient to cover the permanent costs of the tax cut. One way around this problem is to use the trigger each year to generate a one-time tax rebate. The rebate would not be repeated the following year, unless the surplus was sufficiently large. This removes the question of whether the tax cut could be funded but limits the scope of policy that could be undertaken.

B. Tax Policy

Tax policy should be made inside of a budgetary framework that recognizes the importance of other public policy goals—such as education, health, defense, the refurbishing of social security and medicare and so on. In addition, fairness, efficiency, and simplicity remain the core principles of tax policy regardless of the size of the surplus. A number of important tax policies are consistent with these objectives and a prudent budget framework:

--Create a new, lower tax bracket of 10-12 percent, covering a range of income broader than the 10 percent bracket proposed by proposed by President Bush.

--Combine or integrate interactions between the child credit, earned income credit, and personal exemption, along the lines proposed by Sawhill and Thomas (2001), Ellwood and Liebman (2000) or the Economic Policy Institute (2000). This would simplify taxes, improve incentives to work and marry, and provide added resources to low-income households. A crucial element would be to increase the refundability of the child credit.

--Examine the potential for an income tax credit that is based on payroll tax liabilities.

--Simplify the tax code by raising the standard deduction, providing a uniform exclusion for capital gains income rather than the complicated patchwork of capital gains tax rates we currently have, and consolidating the various education programs and the various retirement saving programs.

--Provide tax cuts to high-income taxpayers, and simplify the tax system further, by removing hidden taxes and "take back" provisions. These taxes are imposed even when a taxpayer is complying perfectly with the law, but ends up with what the law has deemed "too many" deductions or "too little" income. These items adversely affect incentives, raise little revenue and create unnecessary complexity.

Personal exemptions are phased out for high-income taxpayers. Two percent of the exemption is eliminated for each $2,500 or fraction thereof that AGI exceeds certain thresholds. The total amount of itemized deductions a taxpayer may claim is reduced by 3 percent of households' income above certain (different) thresholds. These two items can raise effective tax rates by more than 3 percentage points above statutory tax rates, and should simply be repealed.

The major reason individuals get placed on the AMT is that they have high deductions for state and local taxes or large families (Rebelein and Tempalski 2000). This is hardly the egregious tax sheltering behavior that the AMT was intended to capture. Either the AMT exemption should be increased substantially (by $100,000) and indexed for inflation, or the AMT should be abolished. However, before abolishing it, Congress should study what sort of sheltering opportunities would be created and act preemptively to close them off.

--Another way to assist high-income taxpayers is by reforming the estate tax. The effective exemption could usefully be raised and the rates brought down modestly. In addition, the exemptions and rate brackets should be indexed for inflation. Making these changes would provide room to eliminate the most egregious and abusive sheltering practices, of which there are many. (See Gale and Slemrod 2001, or Schmalbeck 2000, for further discussion.)

It would also make sense to decide whether the expiring tax provisions should be made permanent or should be abolished. Finally, there has been substantial discussion of tax rebates. Rebates have the advantage that they can be administered immediately, and they make the most sense either if Congress desires to put money in citizens' hands quickly, or if a tax cut is made contingent upon the size of a surplus. However, as discussed above, tax policy is generally not a useful counter-cyclical policy tool, and making a tax cut contingent on the size of the surplus introduces unnecessary uncertainty.

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